

# HOME STATE TAXATION

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## Foreword<sup>1</sup>

In March 2000, at the Lisbon Summit, Head of States and Prime Ministers of the European Union in the Presidency Conclusions set up a “**new strategic goal**” for the economic development within the Union during the next decade:

*“to become the most competitive and dynamic knowledge-based economy in the world capable of sustainable economic growth with more and better jobs and greater social cohesion.”*

If the European Union is to realise this goal, it is essential that the Internal Market should function as a single market. The tax field remains one of the areas in which there are major obstacles to achieving this end. The following are among the tax obstacles of particular importance that businesses must face in operating across borders within the European Union:

- They must incur the costs of complying with 15 different company tax systems.
- They are usually unable to set losses incurred in one Member State against profits earned and taxed in another Member State.

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<sup>1</sup> This study is based on work started by the Stockholm Group.

The Stockholm Group comprises the following individuals:

Sven-Olof	Lodin	(Sweden)	Albert	Rädler	(Germany)
Robert	Baconnier	(France)	Ad	der Kinderen	(Holland)
Malcolm	Gammie	(UK)	Jim	Hausman	(Canada)
Hugh Ault	(USA)		David	Tillinghast	(USA)

The Group has met regularly since 1993 to discuss corporate tax issues in their respective countries and the development of corporate taxation in Europe and internationally. In 1999 the group proposed a system of “Home State Taxation” in Europe, published in *European Taxation*, 1999, page 286-294, Lodin – Gammie, *The Taxation of the European Company*. The proposal was based on the idea developed by Malcolm Gammie as 1998 Unilever Professor of International Business Law at Leiden University in The Netherlands. This extended and revised version of the original study reflects comments received on papers circulated in 1999-2001 and further work on the proposal by Sven-Olof Lodin and Malcolm Gammie.

- Inter-company pricing is liable to scrutiny in several Member States, each with its own detailed documentary requirements and compliance costs.
- Companies may find it difficult to reorganise their European operations or expand by cross-border acquisitions, without incurring substantial additional tax costs.

There is no indication in the Presidency Conclusions of the Lisbon Summit or in any later decision or statement by the Council, of any concrete proposals to remove these tax obstacles or otherwise for attaining the goal of the new strategy.

The European Internal Market is similar in size to the U.S. domestic market. U.S. businesses benefit, however, from operating within a market that functions as a single market. In the U.S. tax obstacles to the organisation and effective operation of businesses have largely disappeared. As long as the tax issues are unresolved in Europe, however, the Internal Market will be unable to function properly and European businesses will be at a competitive disadvantage to U.S. businesses. This may hamper economic growth within the Union, delaying or preventing the successful realisation of the new strategic goal for the Union. Progress is needed, therefore, to resolve the corporate tax issues.

The simplest and most direct solution would be to introduce a European Company Tax or a common European tax base for enterprises with cross-border activities within the European Union. However, federal solutions or solutions that require far-reaching concessions by Member States and unanimous agreement on technical measures, seem well beyond the political capacity of the European Union for the foreseeable future.

The better prospect appears to be towards voluntary bilateral or multilateral cooperation between Member States rather than binding formal Council decisions. Solutions to the tax obstacles may be more likely to be found in proposals that are based on voluntary agreement and mutual recognition, that honour the principle of subsidiarity and involve only Member States that wish to make progress in this field.

The concept of Home State Taxation has been developed on this basis. It offers a solution that is based on existing corporate tax systems and that minimises the need for agreement on common measures and technical change. It nevertheless largely removes the main tax obstacles to cross-border activity between participating Member States within the European Union.

The simple concept behind Home State Taxation is that the profits of a group of companies active in more than one Member State should be computed according to the rules of one company tax system only—the system of the Home State of the parent company of the group. This is achieved through a voluntary agreement between participating Member States to accept each other's rules for computing taxable profits of domestic groups of companies. Each participating Member State would continue, however, to tax at its own

corporate tax rate its share of the profits of the group's business activities in that State. By using existing national systems, it should be possible to introduce Home State Taxation rapidly soon after an agreement on the main principles is reached.

This paper on a Home State Taxation system does not claim to be comprehensive or to identify and answer all the issues. It sets out to describe the main features of Home State Taxation and to discuss some of the immediate questions to which such a system would raise. The solutions it suggests to particular issues are not the only solutions that could be adopted; indeed other solutions may with further study prove more attractive. Much further work is needed on the detail of the system and on its practical application.

We offer this paper to record our study of this proposal and of the comments that we have received to date on this idea for solving the main company tax problems of cross-border activities within the European Union. As such, it is aimed at improving the functioning of the Internal Market in this field and at making the New Strategic Goal of the Union achievable.

## Summary

1. The idea of a common European corporate income tax system has been discussed for several years. However, in a short or medium term perspective, it seems neither politically nor practically possible to reach agreement on introducing such a system. Such a system might be a long-term goal but other more immediate solutions to the tax problems facing European enterprises are needed.
2. The main problems are these:
  - ◆ Within the European Union today, enterprises have to apply the rules up to 15 different tax systems and to comply with the requirements of 15 different tax authorities, each with their own view of cross-border business within the group. This can involve a heavy compliance burden, double taxation (or non taxation) and timing problems as the systems are unsatisfactorily coordinated.
  - ◆ Frequently enterprises cannot set off losses incurred in one Member State against profits earned in another Member State.
  - ◆ As cross-border transactions increase among related companies, the risks of transfer pricing disputes with tax authorities and of double taxation increase.
  - ◆ Companies may find it difficult to reorganise their European operations or expand by cross-border acquisitions, without incurring substantial additional tax costs.

- ◆ Cross border transactions may also lead to the imposition of withholding taxes, leading to double taxation.

Such factors may distort the way enterprises organise their affairs. The absence of loss offset, for example, may lead multinational firms to locate head offices and other central functions in countries where they have an important market and extensive business. In this way, the existing system favours larger Member States, to the disadvantage of smaller Member States.

3. It might be possible to address some of the problems—for example, the issue of withholding taxes and the tax costs of cross-border mergers—through limited measures in the form of new or amending Community Directives. It seems unlikely, however, that Directives can offer a complete resolution of the problems, nor provide a satisfactory transition to a common system. And the need for a satisfactory basis of corporate taxation within the Union is greater now that Member States have adopted rules governing the status of the *Societas Europaea*. Without a satisfactory taxation regime it seems unlikely that this form of Community institution will be widely used.
4. This paper examines a proposal, known as “Home State Taxation” (“HST”), that is designed to deal with these issues. HST is based on the mutual recognition by each Member State of the other Member States’ corporate tax systems. It respects the Community principle of subsidiarity and is not a compulsory regime that every Member State must agree to and adopt. In this sense it is a minimalist rather than a radical solution.
5. The essential features of HST are these—
  - ◆ Member States with similar systems for computing the taxable corporate income would agree to accept each other’s systems for calculating and consolidating the profits of groups of companies with activities in the Member States participating in HST.
  - ◆ Enterprises headquartered and operating out of a participating Member State would adopt the domestic tax system of that Member State and apply it to their activities in other participating Member States.<sup>2</sup> Thus, the tax base for all activities of a group of companies within the system would be that of a single tax system—the parent company’s Home State.
  - ◆ Participating Member States in which the group conducts its activities would share the tax base among themselves according to a formula (possibly an adjusted VAT base). Each Member State would apply its own corporate tax rate to its share of the group’s taxable profits based on the activities carried on in that State.

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<sup>2</sup> In this respect it is comparable to EMU and Schengen co-operation.

- ◆ For example, a Dutch company would use the Dutch tax system to calculate the profits of all its branches and subsidiaries established in participating Member States, as if all activities were conducted in The Netherlands. The group profits calculated under Dutch rules would be shared between and taxed in those participating Member States in which the company, its permanent establishments and subsidiaries actively conduct their operations. They would pay tax at each Member State's corporate income tax rate on the profits allocated to the enterprise's operations in that State.

6. The HST system contains several important features—

- ◆ National tax systems would not need to be identical. HST should provide an incentive for the main features of tax systems to converge (in so far as they have not already done so) but detailed differences could be tolerated and might remain over time.
- ◆ There would be no need to obtain unanimous agreement to the adoption of Community measures. The system could be implemented through a Convention or similar instrument agreed between those States that were prepared to recognise the tax computation rules of other participating States.
- ◆ The system should not favour any particular Member State or group of States. Member States would share the profits generated by enterprises and each would receive the tax revenue on its share.
- ◆ Tax administrations should benefit from closer co-operation, mutual assistance and information exchange that would have to follow from the application of national tax systems to enterprises headquartered in their State but operating in other participating Member States.
- ◆ It would be unnecessary to resolve the relationship between national corporate tax systems and a new European corporate tax system. HST should also complement the current process of convergence to reduce or eliminate the differences between national tax systems.
- ◆ Existing bilateral tax treaties could continue initially to regulate relationships with third countries.
- ◆ Each State could retain its own company tax rates and dividend taxation system.
- ◆ Member States have recently agreed upon the introduction of the European Company Statute. However, the statute makes no provision for a tax regime for European companies. Such companies will be taxed under the domestic tax laws of the States

in which it is domiciled or active. On this basis the European Company Statute is likely to be of limited significance. Home State Taxation would provide a functioning solution for taxing companies established under the European Company Statute as well as those established under national laws.

7. This study outlines the HST system and considers some of its ‘pros’ and ‘cons’. HST would address each of the issues identified in 2 above. In particular—
- ◆ HST should resolve the major tax obstacles to cross border activities, as the taxable incomes/losses of the parent company and all the subsidiaries and permanent establishments of a group of companies would be consolidated under the Home State’s rules, and the taxable profits of the group as a whole would be calculated under a single set of rules.
  - ◆ Although HST is not a uniform European system, HST would allow an enterprise to apply a single tax system (within those Member States that participate). This would be of particular value to small and medium-sized enterprises seeking to expand their activities outside their Home State as they will be able to continue to apply the same tax system that they have been used to in their existing activities.
  - ◆ HST could operate on a voluntary basis for companies with cross-border activities within the European Union. Enterprises would retain the freedom to calculate their profits and pay tax according to the rules of each country. (Having elected for HST, however, they might only be free to revert to a country-by-country basis in limited circumstances.)
  - ◆ There would be no limits on the size of enterprise that could adopt HST. Thus, both MNEs and SMEs could use the system. This would be important because SMEs are likely to be less able than MNEs to cope with the extra tax burden of international activities under existing systems.
  - ◆ HST would not discriminate against smaller Member States in the way that existing fragmented systems do (see 2 above), and cross-border activity would be not discouraged.
  - ◆ Companies established under the European Company Statute or under the national company law of a Member State would both be able to adopt HST according to where they are headquartered.
  - ◆ Only Member States that wished to participate and that were prepared to recognise the profit calculation rules of other Member States would join the system. The system should lead to further convergence of the tax rules among participating Member States.

This would continue the trend which has already led to a significant degree of convergence between tax systems within EU. The systems of non-participating Member States should also converge as it is likely to be favourable to a Member State to become a member of the HST system once established.

- ◆ There should be little scope for tax competition through special tax measures or ring-fencing, etc. within the HST system. No Member State that applied rules involving “unfair competition” would be accepted into the system by the other Member States unless it had agreed to modify or abandon such rules. In this respect, HST fulfils the objectives of the Code of Conduct.
- ◆ HST would honour the principle of subsidiarity. Each Member State could continue to set its own corporate tax rate and to decide the tax burden on its corporate sector and how its corporate tax rate should interact with the rest of the national income tax system.
- ◆ No harmonisation of tax accounting rules would be needed to introduce the HST system but convergence should be a natural consequence of the system.
- ◆ HST would adopt the existing tax systems. Although HST would be likely to necessitate some change in domestic tax regimes and would involve the application of a formula to divide profits between participating Member States, taxpayers would be familiar with their Home State regime. Existing court practice and interpretations would continue to apply and the problems associated with adopting an entirely new system should be avoided.
- ◆ It should be possible to apply existing bilateral tax treaties in relation to third countries without the need for immediate amendment or for the negotiation of new treaties. Certain third country income (dividends, and income from permanent establishments), however, might have to be excluded initially from the HST system and be taxed under the national rules and treaties of each participating Member State.
- ◆ It would be necessary to devise a practical formula for dividing the consolidated taxable income of the group among the companies and the permanent establishments of the enterprise. Depending upon the formula adopted (possibly a value added based formula) there could be some reallocation of corporate tax revenues amongst Member States as compared to current arrangements.
- ◆ The aggregate corporate tax revenues accruing to Member States could differ to some extent from what they raise at present, to the extent that current revenues arise from inadequate co-ordination of

national tax systems, leading to double taxation and a failure internationally to set off losses against profits.

- ◆ HST does result in several companies conducting the similar activities in the same Member State being subject to different income calculation rules, depending on the Home State of the parent company. However, the basis of the HST system is mutual recognition by each Member State of the profit calculation rules adopted by other Member States. This should limit the differences in taxable income and any potential distortion in competition.
- ◆ HST would demand greater co-operation between the tax authorities than existing systems require. Companies would be responsible for the initial calculation and payment of tax under a self-assessment system. The tax authorities of the Home State would have the main responsibility for auditing and would need only to apply its own tax system in the audit process. They might need assistance from tax authorities in those Member States where subsidiaries were located. The total workload of the tax authorities would probably not increase, but some reorganisation and more international cooperation would be needed. Joint auditing would become a common feature in the system.
- ◆ HST should eliminate transfer pricing issues between group members in different Member States as deviations from arm's length prices between them should automatically be neutralised in the computation and consolidation of profits. It would only be if the allocation formula could be affected by transfer pricing arrangements that manipulations might affect the allocation of profits to Member States. A value added formula would be sensitive to some extent to transfer pricing effects but, typically, the value added base is 4-10 times bigger than a profits base. The manipulation of group finance arrangements should also have no effect on the formula if it were to exclude financial income and expense. This means that any transfer pricing manipulations would have to be considerably larger before they would have any impact. But this should also mean that such manipulations would be relatively easy to detect. Transfer pricing issues should therefore be considerably reduced.
- ◆ Rules would be required to determine which Member State would be the company's Home State and to restrict manipulation of the system by changing the company's Home State. This would include dealing with the tax consequences of merger and acquisition where a group in one Member State acquired another based in a different State.
- ◆ For existing enterprises, there would need to be rules covering the transition from the existing system to HST, so that existing companies and groups were not prevented from entering the tax



system by reason of the tax costs of doing so. If a company chose to adopt HST, the tax effect of doing so for companies ceasing to be subject to the rules of their domestic tax system would be similar to tax emigration. There are likely to be domestic rules dealing with that possibility, although these may have to be supplemented by rules allowing any tax charge on emigration to be postponed. Similar rules may also be needed to cover merger situations.

- ◆ HST should facilitate company reorganisations across the EC, as such transactions would be governed by the rules of a single Member State, the Home State. Home State merger or similar reliefs should therefore apply to mitigate any tax charges that would otherwise arise in such transactions.
8. As this list suggests, there are aspects of HST that are not straightforward and that require agreement between participating Member States. In particular, participating Member States would have to settle on a formula to divide profits and on satisfactory criteria for identifying the Home State and the Home State Group. The inclusion of third country income within the system and existing treaty relationships raise difficult issues. And both taxpayers and tax administrations would have to be prepared to change aspects of their compliance, administration and audit functions to adapt to and implement the system.
  9. The HST-technique, applying tax bases and tax rates from different Member States is not aimed at obtaining more tax neutrality in the sense of export or import neutrality. Instead its aim is to achieve more of tax neutrality for enterprises with cross-border activities within the Union and to remove the extra tax costs caused by the company tax obstacles to cross-border activities resulting from the fragmented company taxation systems in Europe. This would make European businesses more competitive, improve economic growth within the region and produce welfare gains to the inhabitants of the European Union.
  10. HST appears to offer a better possibility of practical implementation and progress on several issues than do proposals for a common tax base or a common European corporate tax system. Indeed HST may represent a transitional mechanism towards the longer term resolution of the European corporate tax issues. If that were confirmed by further study, the proposal would be an important step forward in the completion of the internal market.